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‘Shadow Trading’ and ‘SEC v. Panuwat’: An Expansive Trend in Insider Trading

Judge Orrick’s decision in 'Panuwat' may herald a further widening of the insider trading landscape.

By David I. Miller, Robert A. Horowitz and Charles J. Berk | March 2, 2022 | The New York Law Journal

On Jan. 14, 2022, the U.S. District Court for the Northern District of California denied a motion to dismiss an SEC enforcement action rooted in a novel “shadow trading” theory of insider trading. In *SEC v. Panuwat*, the SEC alleged that Matthew Panuwat used confidential information regarding the acquisition of Medivation, his employer, to buy stock options in another industry participant, Incyte. The court ruled that the SEC alleged facts sufficient to state a claim under the “misappropriation” theory of insider trading for violations of §10(b) of the 1934 Securities Exchange Act and SEC Rule 10b-5 promulgated thereunder. See Dkt. 26 (MTD Decision). Given the unique theory of liability underpinning the SEC’s complaint, the decision may signal a noteworthy expansion in insider trading enforcement.

Insider Trading: A Brief Background

In the absence of a federal statute, insider trading law has developed through judicial interpretation of §10(b) and Rule 10b-5. Insider trading prosecutions generally proceed under one of two theories of liability: the “classical” theory or the “misappropriation” theory.

Under the classical theory, "a corporate insider is prohibited from trading shares of that corporation based on material nonpublic information in violation of the duty of trust and confidence insiders owe to shareholders." *SEC v. Obus*, 693 F.3d 276, 284 (2d Cir. 2012) (citing *Chiarella v. United States*, 445 U.S. 222, 228 (1980)). The typical example is when a company officer violates that duty by trading on material non-public information (MNPI) obtained prior to its release to the general public. This trading constitutes a "deceptive device" as contemplated by §10(b) because the insider's relationship of trust and confidence with the shareholders gives rise to a duty to either disclose the confidential information or abstain from trading. See *Chiarella*, 445 U.S. at 228-229; *Dirks v. SEC*, 463 U.S. 646, 653-54 (1983).

Under the misappropriation theory, a violation of §10(b) and Rule 10b-5 occurs when any person "misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information." *United States v. O'Hagan*, 521 U.S. 642, 652 (1997). This violates §10(b) "because the misappropriator engages in deception … by pretending 'loyalty to the principal while secretly converting the principal's information for personal gain.'" *Obus*, 693 F.3d at 284-85 (quoting *O'Hagan*, 521 U.S. at 653).

Through the years, courts have steadily broadened the scope of trading activity deemed to fall within the ambit of §10(b) and Rule 10b-5, including through litigation over the scope of tipping liability under *Dirks v. SEC*, which held that a tippee can be derivatively liable for insider trading when a tipper (who directly or indirectly personally benefits from disclosure) breaches a fiduciary duty by tipping MNPI to the tippee. See generally *Dirks,* 463 U.S. 646. Judge Orrick's decision in *Panuwat* may herald a further widening of the insider trading landscape.

The 'Panuwat' Complaint's Allegations

Matthew Panuwat was the Senior Director of Business Development at Medivation, a mid-sized oncology-focused biopharmaceutical company. See Dkt. 1 (Complaint) at ¶ 17. Prior to working at Medivation, Panuwat was an investment banker who had specialized in mergers and acquisition deals involving the pharmaceutical industry. See id. at ¶ 21. Panuwat's role at Medivation included pursuing acquisitions and licensing deals. Panuwat tracked the stock prices, drug products, and development pipelines of other biopharmaceutical companies as well as merger and acquisition activity in the biopharmaceutical industry. See id. at ¶ 18.

Upon his employment with Medivation, Panuwat agreed to keep information he learned during his tenure confidential and agreed not to use that information other than for Medivation's benefit. See id. at ¶ 20. Panuwat also signed Medivation's insider trading policy, which prohibited employees from personally profiting from MNPI by trading in Medivation securities or the securities of another publicly traded company. See id.

In April 2016, Panuwat began working closely with investment banks Medivation engaged for the purpose of assessing potential merger partners. See id. at 21. Through this process, Panuwat became familiar with Incyte and learned that both firms were valuable, mid-cap, oncology-focused companies with a profitable FDA-approved drug on the U.S. market. See id. at 22. Panuwat was informed by investment banks that large-cap pharmaceutical companies were interested in acquiring companies with these attributes and that Medivation and Incyte constituted two of only a few such targets that were available to be acquired. See id. Panuwat also knew that a previous announcement of a similar acquisition of a mid-cap oncology-focused company in 2015 had resulted in a material increase in the stock prices of both Medivation and Incyte following the announcement. See id.

In August 2016, Panuwat learned—via a confidential email from Medivation's CEO—that Medivation would be acquired imminently by a large pharmaceutical company at a significant premium to Medivation's stock price. See id. at ¶¶ 26-32. Within minutes of receiving this information, Panuwat (who had never before traded Incyte options logged on to his personal brokerage account from his work computer and purchased Incyte call option contracts with strike prices significantly above Incyte's stock price at the time. See id. at ¶ 33. After the Medivation acquisition became public, the price of Medivation shares rose substantially, and Incyte's stock price soon followed. See id. at ¶¶ 36-37. As a result, Panuwat allegedly earned profits of $107,066. See id. at ¶ 38.

In his motion to dismiss (see Dkt. 18 (Panuwat's MTD)), Panuwat argued that the SEC's "shadow trading" theory (i.e., that Panuwat used inside knowledge regarding his own company to trade profitably in the securities of a competing company), the first time so charged by the Commission, constitutes an attempt to improperly expand the scope of existing insider trading law. See id. at 1. He argued the complaint should be dismissed because it failed to adequately plead: (1) knowledge of the Medivation acquisition constituted material nonpublic information as to Incyte; (2) Panuwat breached his duty to Medivation; and (3) he acted with intent to defraud. See id. at 9-12.

The Court's Decision

The court noted the SEC's claims against Panuwat are premised on the "misappropriation theory" of insider trading law—i.e., that Panuwat knowingly misappropriated MNPI for trading purposes in breach of a duty owed to the source of the information. See MTD Decision at 5. The court walked through each of the necessary elements: materiality; breach of duty; and scienter.

Materiality. On the issue of materiality, Panuwat relied on the language of Rule 10b-5(1)(a) and argued that it requires the SEC to prove a defendant traded in the securities of an issuer on the basis of material nonpublic information "*about that security or issuer*" (see Panuwat's MTD at 9): "The 'manipulative and deceptive devices' prohibited by Section 10(b) of the Act (15 U.S.C. 78j) and §240.10b-5 thereunder include, among other things, the purchase or sale of a security of any issuer, on the basis of material nonpublic information *about that security or issuer*, in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material nonpublic information." 17 C.F.R. §240.10b5-1(a) (emphasis added).

In other words, Panuwat argued that MNPI concerning the Medivation acquisition, which is material to Medivation, cannot be material to Incyte because it is not information "about" Incyte.

In response, the SEC contended that the language of §10(b) and Rule 10b-5 "supports the proposition that information is material to more than one company by broadly prohibiting insider trading in connection with 'any security.'" MTD Decision at 6. To this end, the SEC argued that "it is common sense that information regarding business decisions by a supplier, a purchaser, or a peer can have an impact on a company and therefore be 'about'—or, in other words, 'concerning' or 'relating to'—that company." Id. The SEC further posited that the use of the phrase "include" in Rule 10b5-1(a) suggests that it is not intended to be an exhaustive list of manipulative and deceptive devices that may constitute inside trading. See id.

The court sided with the SEC in finding that "[s]ection 10(b) and Rule 10b-5 cast a wide net, prohibiting insider trading of 'any security' using 'any manipulative or deceptive device.'" Id. at 7. Further, the court noted that "Rule 10b5-1(a) does not state that the information 'about that security or issuer' must come from the security or issuer itself in order to be material.[ ] See §240.10b5-1(a). It only requires that the information be material and nonpublic." Id. Moreover, the court found that Rule 10b5-1(a)'s list of

manipulative and deceptive devices is not exhaustive given the language that "manipulative and deceptive devices *include, among other things* …" Id. (emphasis added).

The court then turned to the critical issue: whether there was a sufficient relationship between the information Panuwat had regarding the Medivation acquisition and Incyte to make the information "about" Incyte. The court found it did, at least for pleading purposes, based on the following allegations, among others: (1) the limited number of mid-cap, oncology-focused biopharmaceutical companies with commercial-stage drugs at the time; (2) that the acquisition of one such company (Medivation) would make others, such as Incyte, more attractive, which could then drive up their stock price; and (3) given the number of other companies who tried to acquire Medivation, it would be reasonable to infer the unsuccessful suitors would turn their attention to Incyte. Based on these allegations, the court concluded the Medivation acquisition was material to Incyte because "a reasonable Incyte investor would consider it important in deciding whether to buy or sell Incyte stock." Id. at 8.

Breach of Duty. Panuwat and the SEC agreed that Panuwat owed a duty of trust and confidence to Medivation. Thus, the issue was whether Panuwat breached that duty by allegedly using information about Medivation's acquisition to purchase Incyte stock options. See id. at 8-9. Panuwat contended that he did not breach his duty to Medivation because the company's insider trading policy did not prohibit trading in Incyte securities. The policy read as follows: "During the course of your employment…with the Company, you may receive important information that is not yet publicly disseminated…about the Company. … Because of your access to this information, you may be in a position to profit financially by buying or selling or in some other way dealing in the Company's securities … *or the securities of another publicly traded company, including all significant collaborators, customers, partners, suppliers, or competitors of the Company*. … For anyone to use such information to gain personal benefit … is illegal. …" Complaint at ¶ 20 (emphasis added).

In Panuwat's view, the SEC did not adequately allege that Incyte was a significant "collaborator, customer, partner, supplier, or competitor" of Medivation, as would be covered by the policy. MTD Decision at 9. The court rejected Panuwat's position, however, again relying on the use of the phrase "including" in Medivation's policy to conclude that the list of the types of companies in the policy are "mere examples of what is covered" as opposed to an exhaustive list. The court concluded that Incyte's status as a publicly-traded company brought it within the ambit of Medivation's insider trading policy. See id.

Scienter. A critical element of illegal insider trading is scienter, which refers to "a mental state embracing intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 n.12 (1976). The court noted uncertainty within the Ninth Circuit as to whether scienter in a civil insider trading case requires a showing that the defendant actually used the MNPI in making the trade or if it is sufficient to show that defendant was simply aware of the information. The court appeared to suggest the latter approach may be the right one given that Rule 10b5-1, which was promulgated after one of the operative Ninth Circuit decisions on the subject, requires that the defendant merely be "aware of" the MNPI. Nevertheless, the court found the SEC's allegations sufficient to satisfy either standard, relying on the fact that Panuwat executed trades "within minutes" of receiving confidential information, combined with the fact that Panuwat had never previously traded Incyte securities. These facts were sufficient—for pleading purposes—to show that Panuwat acted knowingly or recklessly. See MTD Decision at 10-11.

Finally, Panuwat argued that the SEC's claims against him stretch the "misappropriation theory" of insider trading law to an extent that it violates his due process rights, noting that "no one … ever understood the insider trading laws to prohibit the type of conduct alleged [against Panuwat]." Id. at 12. The court rejected Panuwat's contention, however, declaring the notion that information may be material to more than one company (as the SEC claims was the case here) is grounded in "commonsense." See id. Finally, the court

dismissed Panuwat's due process concerns by noting the materiality and scienter requirements for insider trading serve as guardrails against potentially overzealous enforcement. See id. at 13.

Potential Implications

The parties and the court acknowledged that there appear to be no other cases where a company insider has been held liable for insider trading by using MNPI regarding their own company to make a trade involving a company with no connection to their own. See id. at 12. Even though the court only ruled on the sufficiency of the pleading, the prospect of Panuwat's liability raises numerous questions regarding the future of insider trading enforcement efforts.

As just one example, how should corporate insiders determine which companies the SEC may deem "comparable" to their own? While the government has brought enforcement proceedings against corporate insiders and tippees who have traded equities of a closely-connected entity, such as a supplier or direct customer with whom there may have been a confidentiality agreement, the *Panuwat* case appears conceptually distinct in that Incyte and Medivation—despite being similarly-situated companies—share no direct connection to one another and the confidential information at issue did not involve Incyte. Should Panuwat be found liable, where will the line be drawn? Will corporate insiders and/or tippees be at risk anytime they trade in securities of *any* company within their own "industry," especially if the corporate insider trading policy language is broad in scope?

In the case of a merger, how wide can the net be cast? *Panuwat* presents certain unique circumstances on which the SEC relies that may not exist in future cases. Panuwat's prior knowledge of a similar acquisition to the Medivation deal, as well as the scarcity of companies in Medivation and Incyte's market position, are critical underpinnings of the SEC's argument that Panuwat's confidential information regarding Medivation was material to Incyte. If a future case arises involving a larger industry with more players or involving a scenario where markets have not reacted to acquisitions as uniformly as they have in the *Panuwat* case, the government's materiality argument may be less persuasive.

What if a publicly-traded automobile manufacturer develops a proprietary technology that would drastically improve vehicle safety and performance? Will a corporate insider—in light of this development—be prohibited from trading in securities of any company that may be impacted by that proprietary technology?

What if the employer's insider trading policy is narrower than Medivation's, prohibiting only trading in the employer's securities or in the securities of certain categories of companies? Can the employee's use of his employer's MNPI to purchase or sell companies outside the specified categories be deemed a breach of the employee's duty of confidentiality?

In light of the SEC's position and court's decision, issuers, banks, broker dealers, investment advisors, and asset managers should consider taking take the following actions based on this new potential area of insider trading enforcement:

- Assess the impact "shadow trading" liability may have on investment strategies, especially where those strategies may involve interacting or transacting with potentially comparable businesses;
- Review insider trading policies and, where necessary, expand or clarify the language used and entities covered;

- Evaluate current restricted lists and consider expanding them to include potentially comparable companies; and

- Expand employee training and education to ensure that workers are aware of the potential impact and implications of the *Panuwat*

Conclusion

The court's ruling is a significant development in insider trading law. Given the absence of an insider trading statute, this area of the law is frequently subject to novel debate and evolving interpretation. And this case is a noteworthy example. The decision to permit the SEC's "shadow trading" theory to go forward—notwithstanding the relatively indirect relationship between Medivation and Incyte and the absence of previous enforcement of "shadow trading" activity—could have wide-ranging implications for the securities industry. Accordingly, industry participants should take note of this litigation, the court's expansive interpretation of §10(b) and Rule 10b-5, and the case's ultimate outcome.

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